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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Federal-State Joint Board on)
Universal Service)
_____))

CC Docket No. 96-45

**COMMENTS OF
INTERNATIONAL BUSINESS MACHINES CORPORATION
IN SUPPORT OF PETITION FOR RECONSIDERATION**

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Summary

IBM fully supports the Ad Hoc Telecommunications Users Committee's position that systems integrators should not be subject to the Section 254 universal service requirements, and urges the Commission to clarify its Report and Order ("R&O") in this docket in this regard. Systems integrators provide integrated packages of products and services. Like Ad Hoc, IBM believes that imposing a universal service contribution obligation on systems integrators that manage their customers' telecommunications functions as part of an integrated services package will materially impact systems integrators' operations to the detriment of end users and the Commission's own competitive objectives, and cannot be justified by the Commission's public interest concerns.

First, the Commission's competitive neutrality interests are inapplicable since systems integrators and telecommunications carriers, whether common or private, do not compete for the same customers. Moreover, systems integrators already pay for universal service through the rates they pay common carriers pursuant to long term contracts. Thus, there is simply no need to impose a new contribution obligation on systems integrators.

Applying universal service contribution requirements to systems integrators also would result in double payment by the systems integrators. This problem arises because systems integrators would be remitting universal service payments both to the fund administrator based on their retail revenues and to long distance carriers who have incorporated universal service costs into their existing contract rates. In addition, this contribution requirement would unjustly

enrich long distance carriers since systems integrators would continue to pay carriers long term contract rates even though the underlying carriers' costs would be reduced both because carriers will not be paying universal service charges on the wholesale services they sell systems integrators, and because long distance carriers will benefit from net cost savings resulting from the *Access Charge Reform* and *Price Caps* orders.

Complying with the universal service requirement also will prove very costly and complex to systems integrators from an administrative standpoint, far outweighing any negligible benefit that may be gained by adding systems integrators to the universal service contribution base. These costs would be shared by the fund administrator, since the Universal Service Worksheets required by the Commission promise to complicate, not clarify, matters.

Finally, the double payment to long distance carriers, the significant administrative costs and the business disruption will compel many systems integrators to reconsider the value of continuing to manage a customers' telecommunications functions. This by-product of the Commission's R & O directly contravenes the Commission's stated intent *not* to establish regulations that would spur an entity to change how it does business.

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International Business Machines Corporation ("IBM") submits these Comments in support of the Ad Hoc Telecommunications Users Committee's ("Ad Hoc's") Petition for Partial Reconsideration and Clarification¹ of the Report and Order ("R & O") in the above-captioned proceeding.²

INTRODUCTION

IBM is the largest information services company worldwide. IBM creates, develops and manufactures advanced information technologies, including computer systems, software, networking systems, storage devices and microelectronics. In addition, it provides expertise within specific industries, consulting services, system integration and solution development, and technical

¹ Ad Hoc Petition for Partial Clarification and Reconsideration of Report and Order in CC Dkt. 96-45 (filed July 17, 1997) ("*Ad Hoc Petition*").

² *Federal-State Joint Board on Universal Service*, Report and Order, CC Dkt. No. 96-45, FCC 97-157 (released May 8, 1997).

support. Through its systems integration business, IBM offers a broad-ranging package of services and products to customers. This “package” typically includes consulting services, data processing and management, enhanced services, application design and development, equipment maintenance, help desk functions, and associated equipment and functionalities.³ Some customers also ask IBM to include telecommunications in this services package, in which case IBM may manage the customer’s relationship with the customer’s underlying carrier or, as part of a larger services package, privately resell telecommunications obtained from those carriers. IBM does not offer telecommunications on a standalone basis.

Although the Commission did not specifically identify systems integrators as “other providers of interstate telecommunications” subject to universal service contribution obligations under Section 254(d) under the Telecommunications Act of 1996 (“1996 Act”),⁴ Ad Hoc properly raised the concern that Paragraphs 794 through 796 of the R & O could be interpreted to impose a universal service contribution obligation on systems integrators.⁵ Like Ad Hoc, IBM believes that imposing such an obligation would have severe consequences for systems

³ For internal purposes, IBM uses the term “systems integration” more narrowly, in part to accommodate organizational divisions. However, the description of systems integration, as articulated by Ad Hoc, see *Ad Hoc Petition* at 11-12, and recited above, properly identifies the types of products and services IBM provides to its clients, and which properly constitute a systems integration business.

⁴ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (codified at 47 U.S.C. Section 151 *et. seq.*).

⁵ *Ad Hoc Petition* at 11-18.

integrators that cannot be justified by the Commission's competitive neutrality rationale nor its public interest concerns, and therefore urges the Commission to grant Ad Hoc's petition for clarification of this issue.

I. THE COMMISSION'S COMPETITIVE NEUTRALITY CONCERNS ARE INAPPLICABLE TO SYSTEMS INTEGRATORS

Section 254(d) authorizes the FCC to require "other providers" to make universal service support contributions if doing so would be in the public interest.⁶ In the R & O, the Commission in part bases its public interest rationale for including private service providers as "other providers" on principles of competitive neutrality. Specifically, the Commission states that applying universal service obligations to private service providers "reduces the possibility that carriers with universal service obligations will compete directly with carriers without such obligations."⁷ The Commission's competitive neutrality concerns, however, are inapposite with respect to systems integrators.

In discussing its competitive neutrality concerns, the Commission points to its interest in securing contributions from those who "have built their businesses or a part of their businesses on access to the PSTN, provide telecommunications in competition with common carriers, and their non-common carrier status results solely from the manner in which they have chosen to structure their operations."⁸ This statement suggests that the Commission intended to invoke Section 254(d)

⁶ 47 U.S.C. § 254(d).

⁷ R & O at ¶ 795.

⁸ *Id.* at ¶ 796.

primarily to capture those service providers for whom telecommunications services comprise at least a material aspect of their business. Systems integrators, however, are very different.

Unlike common carriers, systems integrators provide telecommunications only as part of much larger managed offerings, which, as described above, typically include consulting, management, and maintenance services entirely disassociated from telecommunications. For systems integrators, telecommunications is generally incidental to their business. For common carriers, telecommunications service *is* their business. Systems integration services would not appeal to customers who want primarily telecommunications services, nor would a telecommunications services provider appeal to those seeking systems integration. In short, systems integrators and telecommunications carriers (common and private) do not compete for the same customers; systems integrators and telecommunications carriers operate in distinctly different markets. Concern over assuring “competitive neutrality” between common and private carriers does not justify extending new direct universal service contributions obligations to systems integrators.

II. SYSTEMS INTEGRATORS CURRENTLY PAY THEIR SHARE OF THE UNIVERSAL SERVICE FUND

Even if competitive neutrality were a legitimate basis for imposing new universal service funding obligations on systems integrators, which it is not, systems integrators should not be subjected to a new universal service contribution obligation for the simple reason that systems integrators *already*

contribute and will continue to contribute to universal service through the rates they pay common carriers for telecommunications services.

Under current multi-year contracts, IBM pays common carriers several hundred million dollars annually for long distance telecommunications and telecommunications services, some small portion of which are eventually resold as part of its systems integration packages. Implicit in the rates charged by the telecommunications carriers for those services are the carriers' universal service costs. The carriers have not reduced these rates, nor has the Commission required them to reduce these rates, to account for the possibility that systems integrators, such as IBM, will be subject to new, distinct universal service contributions under the R & O. Thus, systems integrators already support universal service through the very substantial amounts they pay common carriers.

III. IMPOSING UNIVERSAL SERVICE REQUIREMENTS ON SYSTEMS INTEGRATORS OVER AND ABOVE WHAT THEY CURRENTLY PAY CARRIERS WILL RESULT IN INEQUITABLE DOUBLE PAYMENT BY SYSTEMS INTEGRATORS AND UNJUST ENRICHMENT FOR LONG DISTANCE CARRIERS

The Commission professed to design its universal service contribution mechanism to avoid the "double payment problem."⁹ However, as Ad Hoc argues, imposing contribution requirements on systems integrators will for the foreseeable future *create* such a problem, unjustly enriching long distance carriers along the way.

⁹ *Id.* at ¶ 843.

The double counting and unjust enrichment will likely occur as a result of one of two, or perhaps both, conditions. The first condition is, we believe, unique to systems integrators. Typically, systems integrators are unable to differentiate which portion of services purchased from the underlying carrier will be used by the systems integrators internally or for enhanced services, and which portion will be resold to the integrators' customers. Therefore, under the R&O, the carrier may treat services, including those that will eventually be resold by systems integrators, as retail services and collect universal service contributions from the systems integrators. Under the R & O, systems integrators are also obliged to make universal service contributions on telecommunications that they resell (assuming that the systems integrators develop methods to accurately account for resold basic telecommunications within their systems integration revenues).¹⁰

The second condition causing double recovery will occur when long distance carriers account for revenues from systems integrators as wholesale, not retail, revenues, but do not adjust the rates charged to systems integrators to reflect the fact that the systems integrators will pay universal service contributions. The long distance carriers will hold systems integrators to long term service contracts which do not account for shifting universal service contribution obligations to systems integrators.

¹⁰ See Section IV *infra* for discussion of accounting system problems.

In the R & O, the Commission theorizes that a retail revenues approach is preferable to all other methodologies for assessing universal service contribution obligations because it will not produce “potential economic distortions.”¹¹ In particular, the Commission expresses concern that some underlying carriers “with long-term contracts, may be unable to recover fully [universal service contribution] costs,” and that “uneconomic substitution could result because other carriers would have an incentive to purchase services from those [underlying] carriers, rather than to provide those services with their own facilities, to reduce their direct contribution to universal service.”¹² The Commission, however, failed to further recognize that it is the underlying carriers’ *customers*, and not the carriers, that will be disadvantaged given the net effect of the “Competition Trilogy” orders.¹³

As discussed above, end users, including systems integrators, are currently subsidizing universal service through the fixed rates they pay under contract to their underlying long distance carriers. Under the new universal service system, long distance carriers will face additional funding obligations. Any increase in their universal service contribution requirements, however, will be offset by the two other orders the Commission issued the same day it issued

¹¹ R & O at ¶ 850.

¹² *Id.*

¹³ These include both the R & O, and the *Access Charge Reform/Price Cap* orders, which also were adopted on May 7, 1997. See *infra* notes 14 and 15.

the R & O -- namely the *Access Charge Reform Order*¹⁴ and the *Price Caps Order*,¹⁵ which together will *reduce* a long distance carrier's costs of serving service integrators, like IBM.¹⁶ Yet nothing in any of the three orders requires carriers to pass through these cost reductions to the systems integrators. As a result, systems integrators will be paying twice over for universal service: first, to the long distance carriers who have incorporated their current, and in many cases, prospective universal service costs into the systems integrators' existing contract rates, and second, to the universal service fund administrator, as part of the systems integrators' new obligation to contribute to the universal service fund based on its retail revenues. Long distance carriers will be unjustly enriched because they will not reduce the rates they charge systems integrators to account for the fact that systems integrators will make universal service contributions, while at the same time treating revenues from services provided to

¹⁴ *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, Usage of the Public Switched Network by Information Service and Internet Access Providers*, CC Dkt. Nos. 96-262, 94-1, 91-213 and 96-263, FCC 97-158, First Report and Order (released May 16, 1997) ("*Access Charge Reform Order*").

¹⁵ *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and *Access Charge Reform*, Second Report and Order in CC Docket No. 96-262, FCC 97-159 (released May 21, 1997) ("*Price Caps Order*").

¹⁶ In its Petition, Ad Hoc estimated the net effect of the *Universal Service*, *Access Charge Reform* and *Price Caps* Orders on the costs of providing interexchange carrier using the following assumptions: (1) the multiline business Subscriber Line Charge would increase \$2.00 per month; (2) the multiline business Primary Interexchange Carrier Charge ("PICC") would be \$2.75 per line; (3) the universal service surcharge would be 4% of interstate retail revenues; and (4) the Switched Access Terminating Charge would be reduced by \$0.011 per minute. *Ad Hoc Petition* at 10, note 23. Applying these same assumptions to its own business, IBM estimates that the net effect of the Competition Trilogy orders would be an overall cost reduction on long distance carriers serving IBM.

systems integrators as wholesale revenues on which long distance carriers would not pay universal service contributions.

Arguably, this double payment scenario may be remedied once customers have an opportunity to renegotiate their contracts to allow for a pass through of the underlying carriers' savings under the new regulations. Yet, as noted by the Commission, such an opportunity may not arise for several years, in the meantime producing economic distortions that result in the unjust enrichment of one party at the expense of another.¹⁷ Moreover, long distance carriers have no incentive to renegotiate long term service contracts prior to expiration because the conditions created by the Commission's Competition Trilogy orders allow long distance carriers to retain those cost savings and to shift cost increases to systems integrators. The inequities produced by imposing universal services requirements on systems integrators would create the very type of outcome the Commission clearly and properly rejected in its R & O, and should now seek to remedy.

The net revenue approach, which the Commission rejected in Paragraph 850 of the R & O, would in fact eliminate this double counting problem and any associated distortions, because it would ensure that only that portion of a carrier's revenues that represents value added by the service provider would be assessed a universal service charge. The Commission's dismissal of this remedy is directly attributable to its failure to account for marketplace realities

¹⁷ R & O at ¶ 850.

and the net effect of the Competition Trilogy orders on rates and carrier earnings.¹⁸

IV. THE COMMISSION'S NEW UNIVERSAL SERVICE SYSTEM IMPOSES ON SYSTEMS INTEGRATORS ADMINISTRATIVE BURDENS DISPROPORTIONATE TO THEIR CONTRIBUTION OBLIGATIONS

Systems integrators provide a package of integrated services. They usually neither account for telecommunications revenues separately, nor allocate telecommunications revenues between interstate and intrastate traffic. Under the R & O, universal service contributions will be assessed on the basis of retail interstate telecommunications revenues,¹⁹ requiring systems integrators, on a going forward basis, to do both.

From an administrative standpoint, complying with the universal service requirement will prove extremely costly and complex to systems integrators. It is questionable whether systems integrators will be able to distinguish between basic and enhanced services, and between intrastate, interstate and international services, with the precision required by the Commission's Universal Service Worksheet.²⁰ The costs of redesigning systems integrators' accounting

¹⁸ Additional possible solutions to the double counting problem include permitting systems integrators, in light of the Competition Trilogy, to have a "fresh look" with respect to the rates in the contracts with their underlying carriers. In the alternative, the Commission could simply require carriers to pass through to systems integrators the "net effect" of the Competition Trilogy orders. The long distance carriers have no incentive to voluntarily flow through the "net effect" absent a Commission requirement to do so.

¹⁹ R & O at ¶ 843.

²⁰ See *Changes to the Board of Directors of the National Exchange Carrier Association, Inc.; Federal-State Joint Board on Universal Service*, Report and Order and Second Order on Reconsideration, CC Dkt. Nos. 97-21; 96-45, FCC 97-253 at ¶ 80 and Appendix C (released July 18, 1997) ("Second Order on Reconsideration").

and tracking systems, moreover, will far outweigh whatever benefit the Commission believes it may gain by adding systems integrators to the contribution base.²¹

The administrative burdens associated with applying universal service requirements to systems integrators will not be isolated to the integrators themselves. The Commission's recent decision to require all contributors to file Universal Service Worksheets practically ensures an increase in the cost and complexity of administering the fund. According to the Commission's order, all contributing entities must complete and submit to the Commission a worksheet, by September 1, 1997, designed to collect information on each contributor's gross, end user interstate, intrastate and international telecommunications revenues.²² First, systems integrators do not account for their telecommunications revenues in the manner required under the Worksheet, and to do so, most systems integrators would have to overhaul their current accounting system -- a substantial and costly undertaking that would yield no benefit for systems integrators. The imposition of a new accounting requirement, moreover, would produce a deadweight loss on systems integrators -- a segment

²¹ The systems integration business has developed in a non-regulated, fully competitive marketplace, with its accounting and tracking systems designed to accommodate a competitive model. The Commission's R & O would effectively require systems integrators to adapt their systems to comply with the same regulatory model used by common carriers. Thus, the Commission's Order promises to engulf non-regulated entities into a tangle of regulatory requirements -- contrary to the Commission's stated objective of "achieving Congress's goal of establishing a 'pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening up all telecommunications markets to competition.'" R & O at ¶ 4, quoting S. Rep. No. 230, 104th Cong., 2d Sess.131 (1996) at 1.

²² *Second Order on Reconsideration* at Appendix C, p. C-7.

of the economy whose very existence is based on enhanced efficiency. Second, the worksheet's design promises to complicate, not clarify, matters for the Administrator, particularly where systems integrators are concerned. For example, the Worksheet asks all contributors to classify revenues earned as "retail" or "wholesale" or any combination thereof, without providing any apparent procedure for reconciling the different potential responses. As a result, a single systems integrator resale chain may, depending on each entity's interpretation of its revenues, lead to double recovery of universal service contributions or no recovery at all. It is the Administrator, however, that will be left with the unenviable task of sorting out and reconciling the individual worksheets – in itself an expensive and complex administrative ordeal.

In the R & O, the Commission reasoned that the addition of private providers will "broaden the funding base, lessening contribution requirements on telecommunications carriers or any particular class of telecommunications providers."²³ This logic is erroneous. For example, IBM estimates that the universal service fund may reasonably total \$4.8 billion,²⁴ based on an \$80

²³ R & O at ¶ 795.

²⁴ Based on currently available information, this number is quite plausible. The school and library fund (capped at \$2.25 billion) and the rural health care facilities fund (capped at \$400 million) combined with the 1996 figure for universal service funding (approximately \$1.7 billion, including the Universal Service Fund, Long Term Support, Dial Equipment Minutes Weighting, Lifeline, and Link Up) together total \$4.35 billion. See Monitoring Report, CC Docket No. 87-339, May 1996, Prepared by Federal and State Staff for the Federal-State Joint Board in CC Docket 80-286, Table 1.4; Com. Car. Bur., FCC, Preparation for Addressing Universal Service Issues: A Review of Current Interstate Support Mechanisms (1996). The estimate of \$4.8 billion allows for some growth in the high-cost and low-income support programs.

billion contribution base²⁵ multiplied by a universal service contribution requirement equaling 6% of end user retail revenues.²⁶ IBM further estimates that systems integrators annually purchase and resell approximately \$500 million in telecommunications with an additional markup of approximately 10% (*i.e.* \$50 million) to account for the costs of administering the systems integration contract, the purchase of the telecommunications and the provisioning of telecommunications to customers, and a reasonable profit. This markup constitutes the only revenue potentially added by systems integrators to the universal service contribution base.²⁷ Thus, if one adds systems integrator revenues to the existing universal service contribution base, the new base would approximate \$80.05 billion, which amounts to a percentage increase in the contribution base of 0.0625% or *less than one tenth of one percent* attributable to systems integrator revenues. This additional amount would allow the Commission to reduce the per provider universal service fund contribution percentage from 6% to 5.9996%. Thus, from a practical perspective, the

²⁵ See *Watch 800 Companies Stuff Themselves Into One Phone Booth; In the Long-Distance Market, Lean and Mean Just Gets the Door Open*, The New York Times, Sec. D, p. 1 (Aug. 4, 1997), which estimates long distance telephone revenues at \$82 billion. Because this figure incorporates some revenues which will not be included in the contribution funding base and omits others which will, IBM conservatively rounded this figure to an estimate of \$80 billion.

²⁶ This percentage corresponds to one estimate used by the Commission in connection with its Universal Service Worksheet. See *Second Report on Reconsideration* at Appendix C, p. C-7. A smaller percentage makes the arguments set forth in this section even stronger.

²⁷ This underlying \$500 million represents a rough estimate of the revenue from services purchased from carriers and then resold to end users, exclusive of any markup by the systems integrators. Thus, this revenue has already been included in the contribution base as revenue earned by the underlying carriers. Including this same \$500 million as revenue attributable to systems integrators would constitute double counting. In contrast, the \$50 million represents value added solely by the systems integrator.

inclusion of systems integrators as universal service fund contributors would have virtually no impact on common carrier universal service contributions, and would provide no benefit to the public. By comparison, the cost to systems integrators would be enormous, and the cost and complexity of the Administrator's job would be increased substantially.²⁸

V. THE IMPOSITION OF UNIVERSAL SERVICE FUNDING OBLIGATIONS ON SYSTEMS INTEGRATORS WOULD DETER SYSTEMS INTEGRATORS FROM OFFERING TELECOMMUNICATIONS

Finally, in the R & O, the Commission states explicitly that it does "not want contribution obligations to shape business decisions."²⁹ However, the double counting problem and double recovery by long distance carriers, accompanied by significant administrative costs and business disruption will almost certainly impact the business decisions made by most systems integrators, thereby bringing about the very result the Commission has said it seeks to avoid.

Many systems integrators will need to make significant changes to how they do business. They will need to separate and monitor charges to customers for telecommunications and allocate revenues between the inter- and intrastate jurisdictions. Moreover, many systems integrators will find that the double

²⁸ The Commission's application of the *de minimis* standard provides no relief under such an inequitable situation. For the reasons set forth by Ad Hoc, IBM urges the Commission to reconsider this standard as it is applied to systems integrators. See *Ad Hoc Petition* at 12-14.

²⁹ *Id.* at ¶ 795.

payment significantly raises their cost of doing business, leading them to reevaluate the value of continuing to provide a service that cannot pay for itself.

In the end, however, it is the end user that will be the most compromised by these business decisions – either because the systems integrator raises the user's rates, or because the integrator ceases offering telecommunications altogether, having determined that the provision of telecommunications is simply not worth the added trouble and expense. Systems integration is appealing to many end users precisely because it allows them to focus on their core business by outsourcing certain internal operations, including information processing and the management of their telecommunications. This almost always results in increased efficiency and substantial cost savings to the end user. In addition, in many cases, the user cannot feasibly operate due to a lack of sufficient internal resources, and would benefit from the superior expertise offered by systems integrators. To the extent the Commission's decision causes systems integrators to forgo managing their customers' telecommunications functions, as part of a integrated services package, it denies customers the choices and efficiencies which they have today. These consequences are contrary to the Commission's overall objectives of promoting the broad availability of telecommunications in the marketplace, and contrary to its clear intent not to establish regulations that would cause an entity to change how it does business. These policy considerations alone should compel the Commission to find that systems integrators should not be subjected to the Section 254 universal service requirements.

CONCLUSION

For the foregoing reasons, the Commission should, consistent with Ad Hoc's request for relief, issue an order clarifying that systems integrators will not be required to contribute to universal service support mechanisms.

Respectfully submitted,

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I, Andrew Baer certify that true and correct copies of the preceding Comments of International Business Machines Corporations in Support of the Petition for Partial Reconsideration of the Report and Order in CC Docket 96-45 were served this 18th day of August, 1997 via hand delivery to the following list.

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August 18, 1997